



New Issue: MOODY'S ASSIGNS Aa1 RATING TO CITY OF SEATTLE'S WATER SYSTEM REFUNDING REVENUE BONDS, 2012

Global Credit Research - 07 May 2012

\$1.0 BILLION IN DEBT AFFECTED; STABLE OUTLOOK ALSO AFFIRMED

SEATTLE (CITY OF) WA
Water Enterprise
WA

Moody's Rating

ISSUE	RATING
Water System Refunding Revenue Bonds, 2012	Aa1
Sale Amount	\$229,445,000
Expected Sale Date	05/14/12
Rating Description	Revenue: Government Enterprise

Moody's Outlook STA

Opinion

NEW YORK, May 07, 2012 --Moody's Investors Service has assigned a Aa1 rating to the City of Seattle's Water System Refunding Revenue Bonds, 2012 in the aggregate amount of approximately \$229.5 million. At this time, Moody's affirms the Aa1 rating on approximately \$712.9 million in parity senior lien water revenue bonds. The bonds are secured by a senior lien pledge of net revenues of the city's water utility. Proceeds will be used to refund all or a portion of the system's Water System Revenue Bonds, Series 2001, Series 2003, and Series 2004.

SUMMARY RATINGS RATIONALE

The Aa1 rating primarily reflects the utility's strong service area, adequate supply of high quality water and satisfactory financial operations which benefit from sound financial policies, including a demonstrated trend of regular rate increases.

The stable rating outlook reflects Moody's expectation that the utility's general credit characteristics will remain satisfactory even as the city continues to issue sizable amounts of parity debt to finance its capital program. Future credit reviews will continue to focus on the city's ability to maintain rates and charges sufficient to provide debt service coverage in line with the city's policy level of 1.70 times.

STRENGTHS

- Stable, established customer base supporting retail operations and long-term contracts with wholesale customers
- Strong management with proven commitment to rate increases; access to sizable city-wide cash pool for liquidity
- High quality water supply

CHALLENGES

- Narrowed senior lien debt coverage levels below internal target
- Above-average debt ratio

DETAILED CREDIT DISCUSSION

LARGE SERVICE AREA AND STABLE CUSTOMER BASE; LONG-TERM DOWNWARD TREND IN WATER CONSUMPTION DESPITE POPULATION GROWTH

The system serves the City of Seattle (UTGO Aaa/STA) and nearby suburban communities including its largest wholesale customer, the City of Bellevue (UTGO Aaa/STA, water revenue Aa2) through its membership in the Cascade Water Alliance. The customer base is diverse and growing, including a total of 22 wholesale customers in surrounding suburban King County (rated Aaa/STA). Seattle's population growth has been moderate, but steady increases in customers are expected to continue in the outlying areas. Water demand, however, has been decreasing as a result of a greater focus being placed on conservation by Seattle and its wholesale customers. Weather also plays an important role in water consumption, as below-average temperatures over the last two summers have resulted in decreasing demand.

The City of Seattle is the heart of the Puget Sound region, and the commercial hub of the Pacific Northwest. The computer services and aircraft sectors are key components of the diverse regional economy. Seattle's economy remains on the recovery path because these primary employers continue to expand, and employment levels have almost completely recovered to pre-recession levels. Employment growth has been steady over the last two years, and the city's unemployment rate of 7.1% (February 2012) remains well below that of the state (9.1%) and the nation (8.7%). Full value per capita, at \$191,892, remains very high for a major metropolitan city. Wealth levels are also fairly high for a large city, with 2006 - 2010 estimated median family income of \$87,987, or 139.7% of the U.S.

HIGH QUALITY WATER SUPPLY; CONSERVATIVE FORECASTING OF CONSUMPTION

Water is supplied by the Cedar and Tolt rivers flowing from the Cascade Mountains. The Cedar River provides the city with 82,000 acre feet of raw water storage while the Tolt River supplies 56,000 acre feet of raw water storage. The city's ownership of most of the forested watershed, combined with cooperative agreements with other land owners has helped protect the supply of high quality water, and officials estimate having sufficient water supply to meet growth through 2060. Existing sources of supply owned by the City provide an average annual firm yield of 172 MGD. The current firm yield is based on an update completed in 2011 to represent current operating conditions, including the use of the current spring refill target of elevation 1,563 feet for Chester Morse Lake and the use of a revised monthly demand distribution based upon the actual demand in 2005 through 2009. Demand in the service area has averaged less than 130 MGD since 2005. Successful demand-management efforts are expected to delay the need for additional water supply for several years.

CAPITAL IMPROVEMENT PLAN TO FOCUS ON MAINTENANCE AND DISTRIBUTION

The utility's capital improvement plan remains sizable, though Moody's believes that the city will continue to successfully manage the challenges associated with such a large program. The city has a proven track record of delivering large projects and has successfully maintained public support during a period of sizable rate increases. The 2012-2017 capital plan reflects a total of \$379.7 million of system needs, with the majority of spending focusing on the maintenance of physical infrastructure in the distribution system. Projects include completion of covers for the remaining open reservoirs to ensure water purity as required by state regulations; the Morse Lake Pump Plant, which will increase access to water stored in Morse Lake and help the utility respond to drought situations; water system improvements associated with construction projects in the City's streets, highways, and bridges; and investments in the Cedar River watershed mandated by the federal government in the Habitat Conservation Plan. The current capital plan substantially close out the era of major projects in the Water Fund, transitioning from the building of major assets to maintaining, rehabilitating and replacing the physical infrastructure for distributing water to retail customers. The current plan also includes many ongoing programs, such as improving the distribution system of water mains, valves, and pump stations.

The bonds are secured by a senior lien pledge of net revenues of the city's water utility. The rate covenant is equal to 1.25 times annual debt service (including adjustments for rate stabilization draws and deposits). The additional bonds test is also 1.25 times. The debt service reserve fund requirement is equal to the lesser of maximum annual debt service or 125 percent of average annual debt service and will be funded with bond proceeds. Proceeds will be used to refund all or a portion of the system's Water System Revenue Bonds, Series 2001, Series 2003, and Series 2004.

Most of the system's future financing will be provided through the issuance of additional bonds (54%) and from internally generated funds (46%). While the system's debt ratio is high at 76.7% in 2011, Moody's anticipates that the city will continue to implement rate increases to support additional borrowing at coverage levels well above the 1.25

times rate covenant. The current refunding issue is estimated to generate \$24.9 million (an average of \$1.5 million per year) in debt service savings over the life of the bonds.

OPERATIONS BENEFIT FROM STRONG FISCAL MANAGEMENT AND HISTORY OF RAISING RATES

The city's willingness and ability to implement required rate increases remains a fundamental credit strength of the water utility, despite somewhat thin coverage levels which have remained below the city's budgeting target since FY 2008. The city has implemented annual rate increases, usually in January of each year, ranging from a high of 14.5% in fiscal 2003 to a modest 0.6% in fiscal 2011. Rate increases were 11.7% and 9.3% in FY 2009 and FY 2010, respectively. In addition, a 10.2% temporary surcharge was implemented for retail rates on March 31, 2009 which remained in effect through December 31, 2010 to cover litigation costs. Despite recent fluctuations in operating revenue resulting from economic conditions, increased city taxes, and declining water demand, city officials have maintained stable debt service coverage levels through consistent rate increases and planned draws from the Rate Stabilization fund (RSF) in FY 2010 and 2011 down to the city's target balance of \$9.0 million. Between FY 2009 and FY 2011 senior lien and total lien coverage averaged 1.56 times. Operating results in FY 2009 reflect an asset sale of \$8.8 million, a temporary increase in the city tax rate to cover litigation costs, and a refunding of certain subordinate lien debt through the issuance of parity bonds increasing the senior lien debt service.

The city currently has a financial policy of 1.70 times coverage of debt service on a planning basis and has had difficulty meeting that target in recent years, although projections indicate coverage of 1.73 in FY 2014. Senior lien coverage averaged 1.59 times from FY 2007 to FY 2011. In fiscal 2010 annual senior lien coverage was 1.58 times while total annual debt service coverage was 1.57 times. Due to weather-related reductions in water consumption during FY 2010 and 2011 and increasing debt service requirements, senior lien coverage decreased to 1.48 times with total debt service coverage of 1.46 times. Projected FY 2012 senior lien increases to 1.65 times with total debt service coverage of 1.62 times driven by a large rate increase of 12.2% and lower senior lien debt service from savings generated in the current refunding issue.

The water system's net working capital (which does not include approximately \$15.7 million in unspent bond proceeds) is low at 9.5% of O&M in 2011. Unrestricted days cash on hand (which includes the \$9.0 million rate stabilization fund balance) is also modest at 70 days. Moody's notes, however, that Seattle's utilities have access to sizable balances in the city-wide combined cash pool of about \$1.2 billion to meet liquidity needs.

Outlook

The stable rating outlook reflects Moody's expectation that the utility's general credit characteristics will remain strong even as the city continues to issue sizable amounts of parity debt to finance its large capital program. Future credit reviews will focus on the city's ability to maintain rates and charges sufficient to provide debt service coverage equal to or greater than its policy level.

WHAT COULD MAKE THE RATING MOVE UP

- Trend of extraordinary growth in operating revenue sources resulting in sustained healthy debt service coverage
- Significant increase in liquidity and reserves

WHAT COULD MAKE THE RATING MOVE DOWN

- Deterioration in pledged revenues and coverage
- Significant draw on available city-wide cash reserves

KEY STATISTICS

Type of system: Retail and wholesale water system

Estimated service area population: 1.3 million

Number of water accounts, 2011: 184,425

Total water customer average annual growth, 2007 - 2011: 0.5%

Fiscal 2011 Ratios:

Operating ratio: 44.1%

Senior lien annual debt service coverage: 1.48 times

Total annual debt service coverage: 1.46 times

Senior lien maximum annual debt service coverage: 1.48 times

Net working capital as a % of O&M: 9.5% (\$8.1 million)

Days cash on hand (unrestricted): 70

Debt ratio: 76.7%

Projected Fiscal 2012 Ratios:

Operating ratio: 42.9%

Senior lien annual debt service coverage: 1.61 times

Total annual debt service coverage: 1.59 times

Senior lien maximum annual debt service coverage: 1.63 times

PRINCIPAL RATING METHODOLOGY

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published in August 1999. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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